

The President's
Tax Proposals
to the Congress for
Fairness, Growth,
and Simplicity



May 1985

Summary

THE PRESIDENT'S PROPOSALS
FOR FAIRNESS, GROWTH, AND SIMPLICITY

SUMMARY

The President's proposals would reduce tax rates, reduce complexity, increase fairness, and increase growth. The following is a summary of the proposals and their rationale.

I. THE PROBLEM WITH
THE CURRENT TAX SYSTEM

(A) The overwhelming majority of Americans are dissatisfied with the current tax system. They are concerned because:

(1) The system is unfair.

- People are troubled by stories of wealthy individuals and healthy corporations paying little or no taxes.
- They can't understand the logic or equity of people in seemingly similar situations paying dramatically different amounts of tax.
- They read or hear of one tax break after another -- from credits for investments in windmills to deductions for "educational" cruises on ocean liners -- and know that they are not getting the benefit of such breaks.
- They are skeptical of the economic justification of many tax shelter schemes -- and see them as tax dodges.

(2) The system is too complicated.

- For some, it seems a difficult -- and sometimes even ridiculous -- administrative burden. About half of all Americans seek professional tax advice; no doubt, more feel they may need it.
- And while others may not find the system so burdensome, they often resent complexity nonetheless: They sense it is unfair -- that complexity is the means by which some benefit while others do not.

(3) The current system needlessly impedes growth.

- By encouraging investment for purposes of tax reduction rather than for independently worthy economic purposes, it prevents the market from allocating resources as efficiently and productively as it might.
- By taxing workers' earnings at excessive rates -- or by being perceived as taxing unfairly -- it discourages work, saving, productivity, innovation, and growth.
- Thus, it prevents workers and the economy from reaching their full potential.

(B) As dissatisfaction increases, the continued viability of the tax system is threatened -- and as it is threatened, so too is the basis of support for essential governmental services and functions.

- (1) The "underground economy" and the "tax gap" (taxes owed but not paid) are large and thought to be growing. The American tradition of voluntary tax compliance is being eroded.
- (2) Efforts to increase compliance within the framework of the current system seem not only to have reached the point of diminishing returns. They often seem to be counter-productive: They increase resentment and disrespect for a system that cannot long function without a firm foundation of public confidence.

(C) Americans want change.

America was born in a revolutionary context that grew out of popular resentment of an unfair tax system. Two centuries later, another revolution is quietly growing. It is a peaceful revolution -- but again it is born of popular resentment of a tax system that has gone awry.

Americans want a new system. This is not a conventional partisan matter. The tax reform movement has strong advocates within both political parties. With bipartisan effort and cooperation, Americans can have the new system they want and deserve: a system that interferes less with economic choices; that promotes growth; that is simpler; and, perhaps most importantly, that people perceive to be fair.

II. THE PRESIDENT'S
PROPOSALS FOR REFORM

To increase growth, reduce complexity, and make the system more fair, the President has proposed a comprehensive set of reforms. The following are key features:

(A) PERSONAL RATE REDUCTION:

Personal income tax rates must be lowered substantially as the tax base is broadened.

- (1) The President's proposals would eliminate the present system of 14 brackets of tax rates ranging from 11 to 50 percent. In its place would be a simple 3-bracket system -- with tax rates of 15, 25, and 35 percent.

(For joint returns, the rates would be: 0% up to \$4,000 in taxable income; 15% on the amount from \$4,000 to \$29,000; 25% on the amount from \$29,000 to \$70,000; and 35% on the amount over \$70,000.)

-- Marginal tax rates would be reduced by an average of 19 percent.

-- Average tax rates would be reduced for all income classes.

-- Total taxes paid by individuals would be reduced by 7 percent.

- (2) The complex system of itemized deductions, exclusions, and special credits would be substantially simplified and reformed. More than 65 categories of preferential tax treatment would be eliminated or curtailed. For example:

-- Deductions for entertainment and business meal expenses would be limited.

-- The deductibility of state and local taxes -- which contributes to the problem of high federal tax rates, and which can be conceived as a special subsidy to high-income taxpayers in high-tax states -- would be repealed.

-- Unemployment and disability payments (with the exception of veterans' disability payments) would be treated as income.

- Relatively narrow tax benefits available only to a few -- like "business" deductions for educational seminars on cruise ships or for the use of sky-boxes at sporting events -- would be eliminated. Similarly, such tax abuses as those associated with income shifting to minor children or to certain trusts would be limited.
- (3) Only a limited number of special deductions and exclusions would be retained -- principally those that are widely used, and generally judged to be central to American values. For example:
 - In view of America's unequivocal commitment to private home-ownership, the home mortgage interest deduction would be retained for a taxpayer's principal residence.
 - In view of America's special obligations to Social Security beneficiaries and disabled veterans, the current preferential treatment of Social Security and veterans' disability payments would be retained.
 - And in view of America's longstanding commitment to charity and voluntarism, the itemized deductions would be retained for charitable contributions.

(B) SUPPORT FOR FAMILIES:

Insofar as the tax system affects the American family, it should contribute to strengthening it rather than weakening it. Accordingly:

- (1) The President's proposals would increase the personal exemption to \$2,000 as of January 1, 1986 for each taxpayer and dependent -- and would index this amount to protect against inflation.
- (2) The "earned income tax credit" for the working poor would be increased and indexed to protect against inflation.
- (3) The incentive for private saving through Individual Retirement Accounts (IRAs) -- now available to all wage-earners -- would be expanded to afford the same benefit to spouses working in the home.

(C) FAIRNESS FOR THE POOR:

The tax system should not be an additional burden to those who are struggling to escape from poverty; insofar as possible, those below the poverty line should be freed from taxation altogether.

By raising the personal exemption, the "zero bracket amounts," and earned income tax credit, and by expanding the credit for the blind, elderly, and disabled, the President's proposals would:

- (1) assure that virtually all families at or below the poverty line would be freed from taxation; and
- (2) assure that virtually all older, blind, or disabled Americans at or below the poverty line would be freed from taxation.

(D) RETURN-FREE FILING:

The administrative burden on individuals should be reduced, not increased.

If the President's proposals are adopted, the number of taxpayers likely to itemize will be reduced to only 33 percent. And it will be possible to administer a "return-free" filing system that would permit more than half of all taxpayers to receive an appropriate tax bill or refund without ever having to file a return. This system would be entirely voluntary. At the taxpayer's discretion, the administrative burden would be borne by the IRS based on information already scheduled to be available to it.

(E) INCENTIVES FOR GROWTH:

The tax system should, insofar as possible, foster economic growth by encouraging work, saving, and investment; rewarding risk-taking from which there is general benefit; and allowing resources to be allocated efficiently on the basis of economic rather than tax considerations. With this in view:

- (1) Changes in the tax system for individuals -- reducing rates and increasing the perception of fairness -- should increase incentives for work, saving, investment, risk-taking, and innovation. In addition, a more efficient and productive economy and faster growth would be fostered through the following, which relate primarily to business taxation.

- (2) Special subsidies or preferences for specific industries or sectors should be curtailed except where there is a clear national security interest that argues to the contrary. Accordingly, the President's detailed proposals include limitations on preferences that are now available to:
- banking;
 - insurance;
 - mining;
 - timber;
 - oil and gas; and
 - non-government beneficiaries of tax-exempt bonds.
- (3) Distortions of investment patterns resulting from unjustifiable tax shelter schemes should be reduced -- as, for example, through the extension of "at risk" rules to the real estate sector.
- (4) Incentives for investment in research and experimentation should be preserved through a more accurately targeted credit for such investment.
- (5) Incentives for higher-risk venturing -- from which there is often greater social gain -- should be provided by excluding from taxable income 50 percent of long-term capital gains. (This would reduce the present maximum capital gains tax from 20% to 17.5%.)
- (6) Tax-induced distortions among differing categories of investment should be reduced, while avoiding an overall increase in the cost-of-capital. To this end:
- The investment tax credit should be repealed and the accelerated depreciation system should be revised and indexed for inflation to bring effective tax rates closer together for different categories of investment.
 - Firms using the "FIFO" (first-in-first-out) inventory accounting system should also be allowed to index the value of inventories for inflation (or to use "LIFO" without the conformity obligation).

- To alleviate the double taxation of dividends, the principle of corporate dividend deductibility should be established with an initial deductible amount of 10 percent.
 - The maximum corporate tax rate should be reduced to 33 percent -- keeping it roughly in line with the maximum individual rate.
- (7) Small business formation and development -- from which much of America's extraordinary job-creation comes -- should be facilitated through a graduated corporate rate structure that benefits small business and is phased out for larger ones.

NOTE RE GROWTH AND "REVENUE NEUTRALITY":

Taken together, the President's proposals are "revenue neutral" (plus-or-minus 1.5% of total revenues) -- using conventional estimating procedures, without changing macro-economic assumptions. That is, under these assumptions, the proposals would, when fully effective, raise virtually the same amount of revenue as current law.

For reasons suggested above, it is reasonable to expect improved economic performance as a result of the President's tax proposals. The Treasury Department estimates that the effect of the proposals would be to cause real GNP to be at least 1.5 percent higher by 1995 than it would be under current law. Because of the inherent uncertainty in such forecasts, however, this additional growth has not been added to Administration forecasts and is not reflected in higher revenue estimates.

(F) OVERALL FAIRNESS OF CHANGES:

In addition to the increased perception of fairness that derives from rate reduction, base-broadening, and the elimination of special preferences, it is important that the overall effect of the proposals be deemed fair when judged by such measures as the following:

- (1) The number of taxpayers who "win" and who "lose": The President's proposals would produce benefits or no change in individual tax liabilities for 79 percent of families and losses for only 21 percent of families. This pattern holds across all income groups -- and is strongest in the lowest income categories. (Even those whose taxes would not change would benefit from simplification and increased fairness.)

- (2) The pattern of tax reductions by income class: The President's proposals would reduce total individual income taxes by 7 percent overall. The amount of taxes paid by those in the lowest three income categories would be reduced by the largest percentages, an average of 18.3 percent.
- (3) The distribution of the overall tax burden by income class: The President's proposals would result in roughly the same percentage of total revenues being contributed by each income class as is contributed under current law -- except for the poor, who would pay a much smaller percentage.
- (4) The effects on those at or below the poverty line: The President's proposals would remove from income taxation altogether virtually all families, married couples, single heads of households, and older Americans at or below the poverty line.
- (5) The number of economically healthy, income-earning individuals and corporations who may escape taxation altogether: The President's proposals to reform individual and corporate taxes will substantially reduce incentives and opportunities to escape all income taxation ("zero out"). As additional assurance that some contribution is made by all economically healthy, income-earning individuals and corporations, the proposals also include minimum tax requirements for both individuals and corporations.
- (6) The distribution of the tax changes between corporations and individuals: This is not a particularly relevant economic measure; but it is often judged to be important as a matter of perception. When fully effective, the President's proposals would raise total corporate tax payments by an estimated 9 percent, and would lower total individual tax payments by 7 percent.

Charts that amplify these points are attached. Also attached, for summary reference purposes, is a chart that compares current law, the November 1984 Treasury Department proposals, and the President's May 1985 proposals. Detailed discussion of the President's proposals is provided in the associated volume.

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Chart 1

Comparison of Marginal Tax Rates Under Current Law and Proposal for 1986 Single Returns

Current Law <u>1/</u>		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than \$ 2,480	0	0	Less than \$ 2,900
\$ 2,480 - 3,670	11		
3,670 - 4,750	12		
4,750 - 7,010	14		
7,010 - 9,170	15	15	\$ 2,900 - 18,000
9,170 - 11,650	16		
11,650 - 13,920	18		
13,920 - 16,180	20		
16,180 - 19,640	23	25	18,000 - 42,000
19,640 - 25,360	26		
25,360 - 31,070	30		
31,070 - 36,790	34		
36,790 - 44,780	38	35	42,000 or more
44,780 - 59,670	42		
59,670 - 88,260	48		
88,260 or more	50		

Office of the Secretary of the Treasury

May 28, 1985

1/ Estimated.

Chart 2

Comparison of Marginal Tax Rates Under Current Law and Proposal for 1986 Joint Returns

Current Law <u>1/</u>		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than \$ 3,670	0	0	Less than \$ 4,000
\$ 3,670 - 5,930	11		
5,930 - 8,200	12		
8,200 - 12,840	14		
12,840 - 17,260	16	15	\$ 4,000 - 29,000
17,260 - 21,800	18		
21,800 - 26,540	22		
26,540 - 32,260	25		
32,260 - 37,980	28	25	29,000 - 70,000
37,980 - 49,420	33		
49,420 - 64,740	38		
64,740 - 92,360	42		
92,360 - 118,040	45	35	70,000 or more
118,040 - 175,230	49		
175,230 or more	50		

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1/ Estimated.

Chart 3

Comparison of Marginal Tax Rates Under Current Law and Proposal for 1986 Head of Household Returns

Current Law <u>1/</u>		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than \$ 2,480	0	0	Less than \$ 3,600
\$ 2,480 - 4,750	11		
4,750 - 7,010	12		
7,010 - 9,390	14		
9,390 - 12,730	17	15	\$ 3,600 - 23,000
12,730 - 16,180	18		
16,180 - 19,640	20		
19,640 - 25,360	24		
25,360 - 31,070	28	25	23,000 - 52,000
31,070 - 36,790	32		
36,790 - 48,230	35		
48,230 - 65,390	42		
65,390 - 88,260	45	35	52,000 or more
88,260 - 116,850	48		
116,850 or more	50		

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1/ Estimated.

Chart 4

**MARGINAL RATES OF TAX
BY FAMILY ECONOMIC INCOME
Current Law and President's Proposal**

Marginal Tax Rate

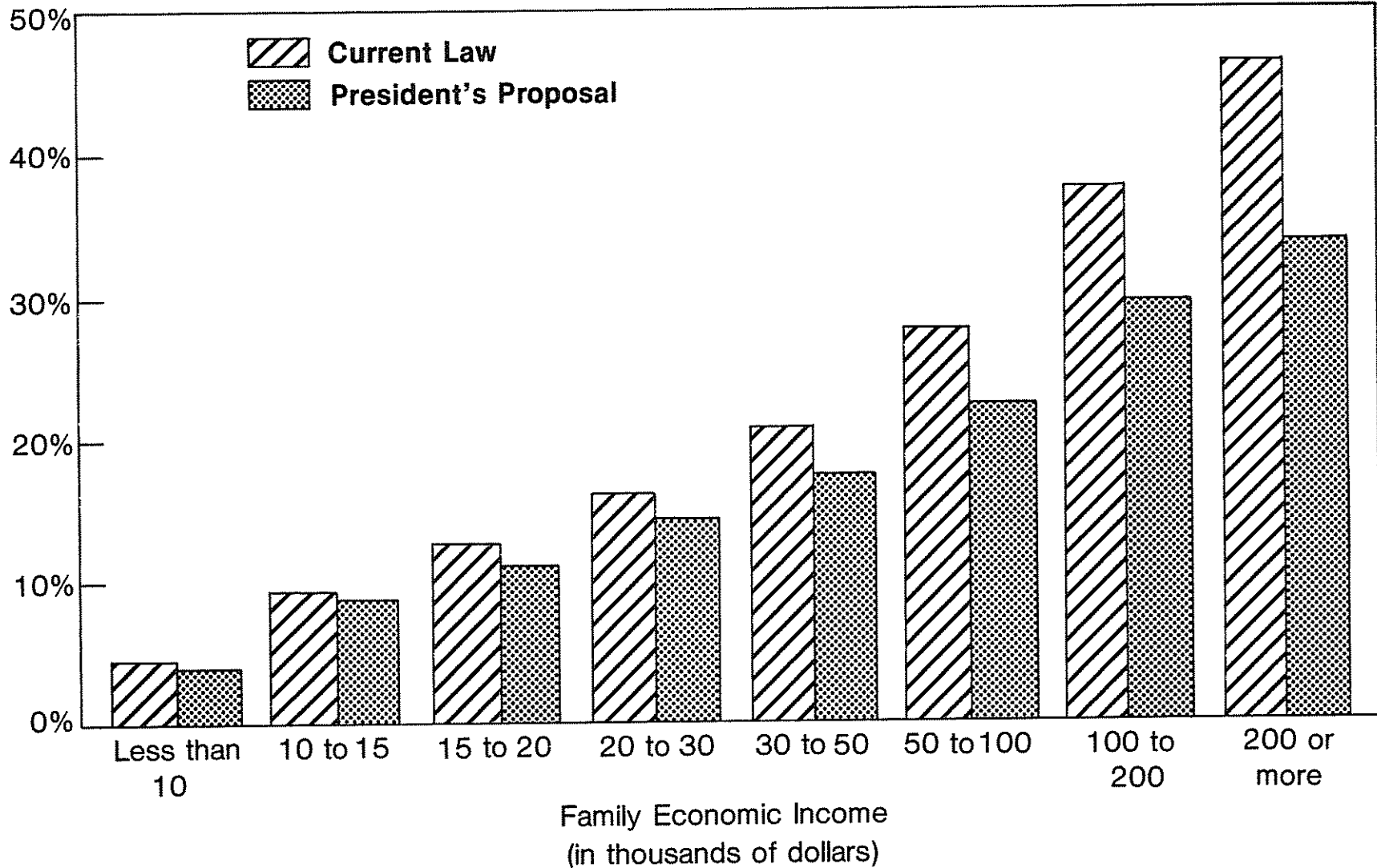


Chart 5

AVERAGE RATES OF TAX ON FAMILY ECONOMIC INCOME Current Law and President's Proposal

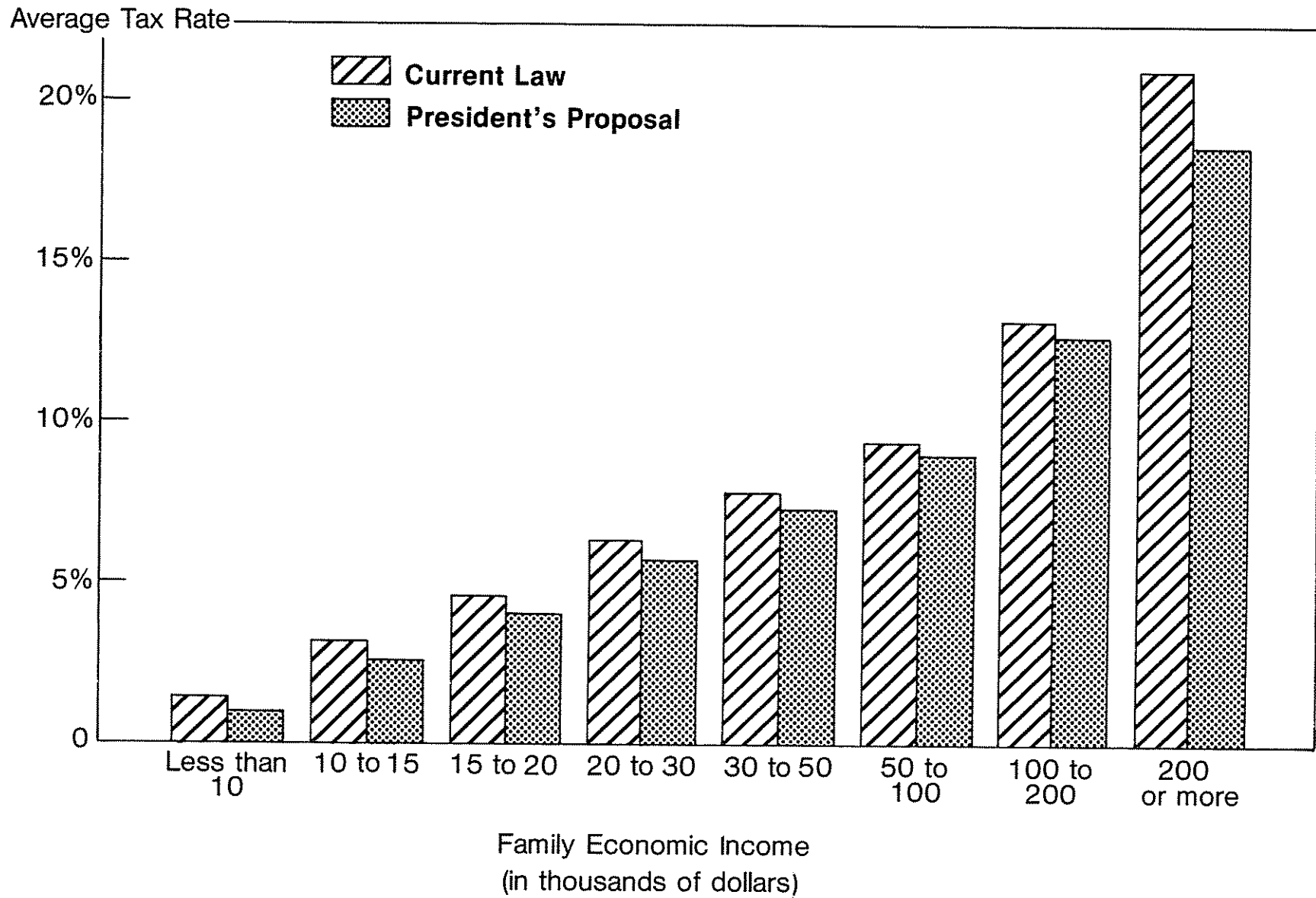


Chart 6

**PERCENTAGE TAX REDUCTION
Under the President's Proposal**

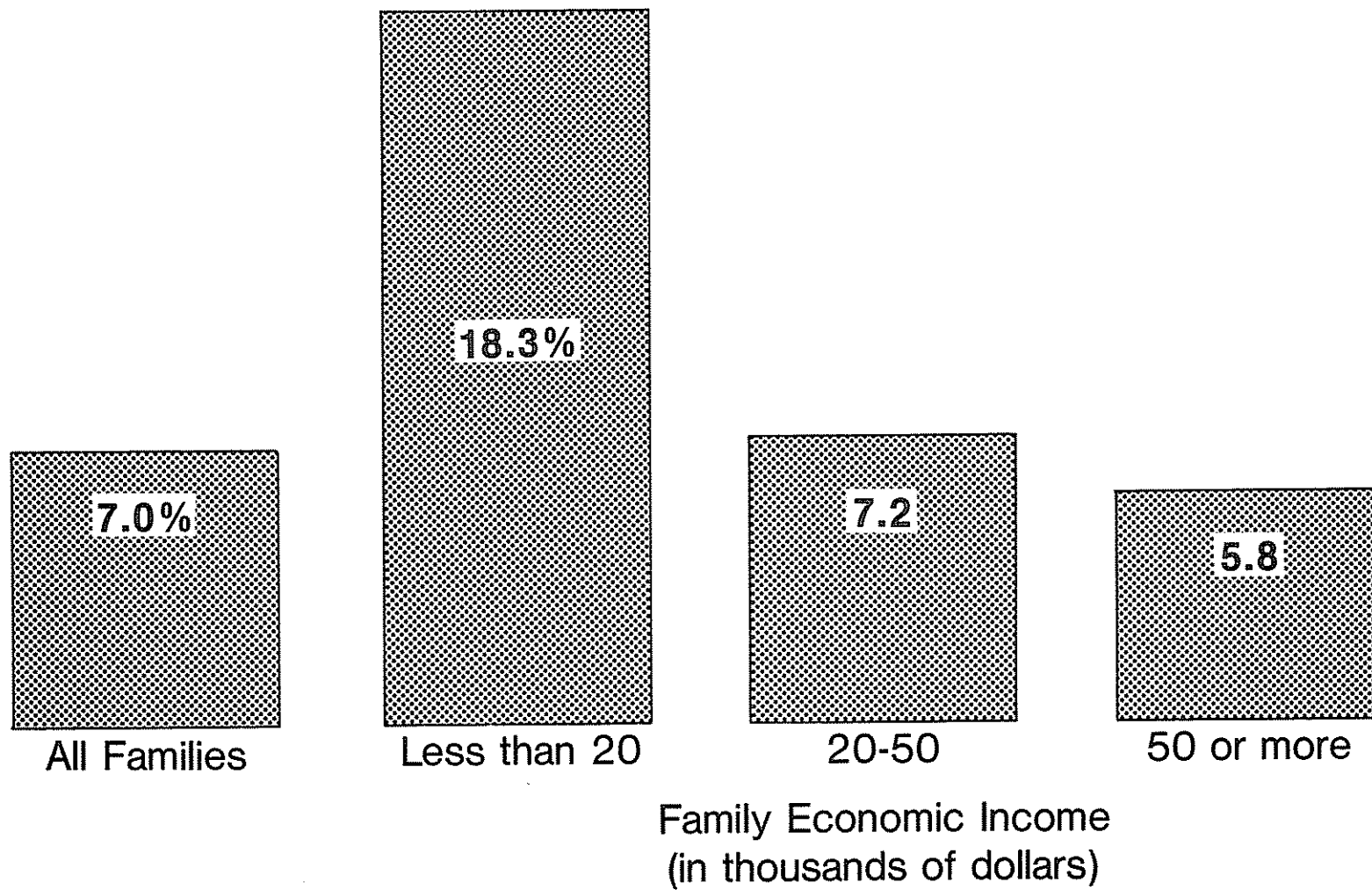


Chart 7

PERCENTAGE TAX REDUCTION BY FAMILY ECONOMIC INCOME Under the President's Proposal

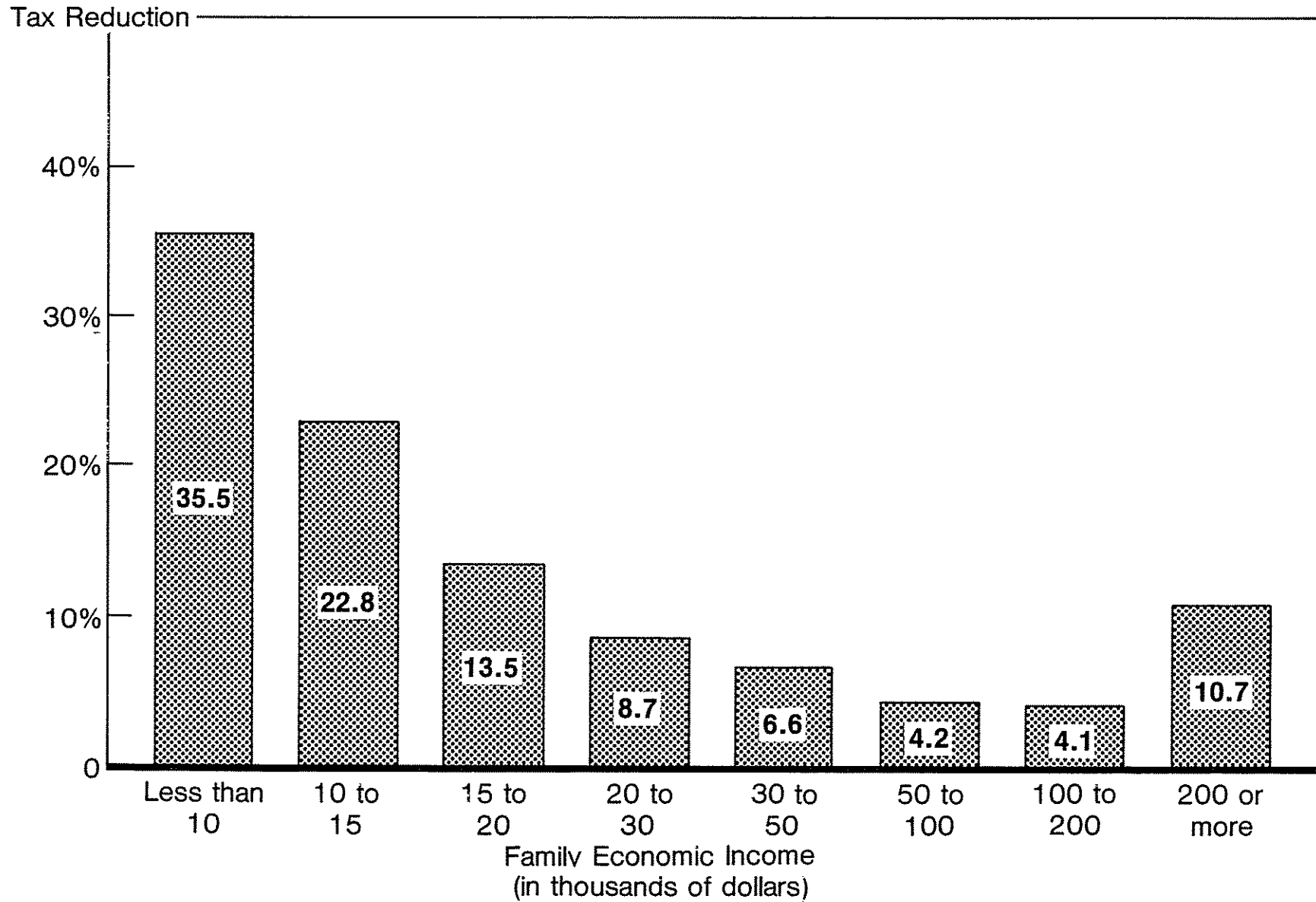


Chart 8

Average Tax Rate and Change in Taxes Paid by Income Class

Income Class	Average Tax Rate		Change in Taxes
	Current Law	President's Proposal	
Less than \$10,000	1.4 %	0.9 %	-35.5 %
\$10,000 - \$15,000	3.2	2.5	-22.8
\$15,000 - \$20,000	4.6	4.0	-13.5
\$20,000 - \$30,000	6.3	5.7	-8.7
\$30,000 - \$50,000	7.8	7.3	-6.6
\$50,000 - \$100,000	9.4	9.0	-4.2
\$100,000 - \$200,000	13.2	12.7	-4.1
\$200,000 and Over	21.0	18.7	-10.7
Total	8.7 %	8.1 %	-7.0 %

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Chart 9

PERSONAL EXEMPTION
Current Law and President's Proposal

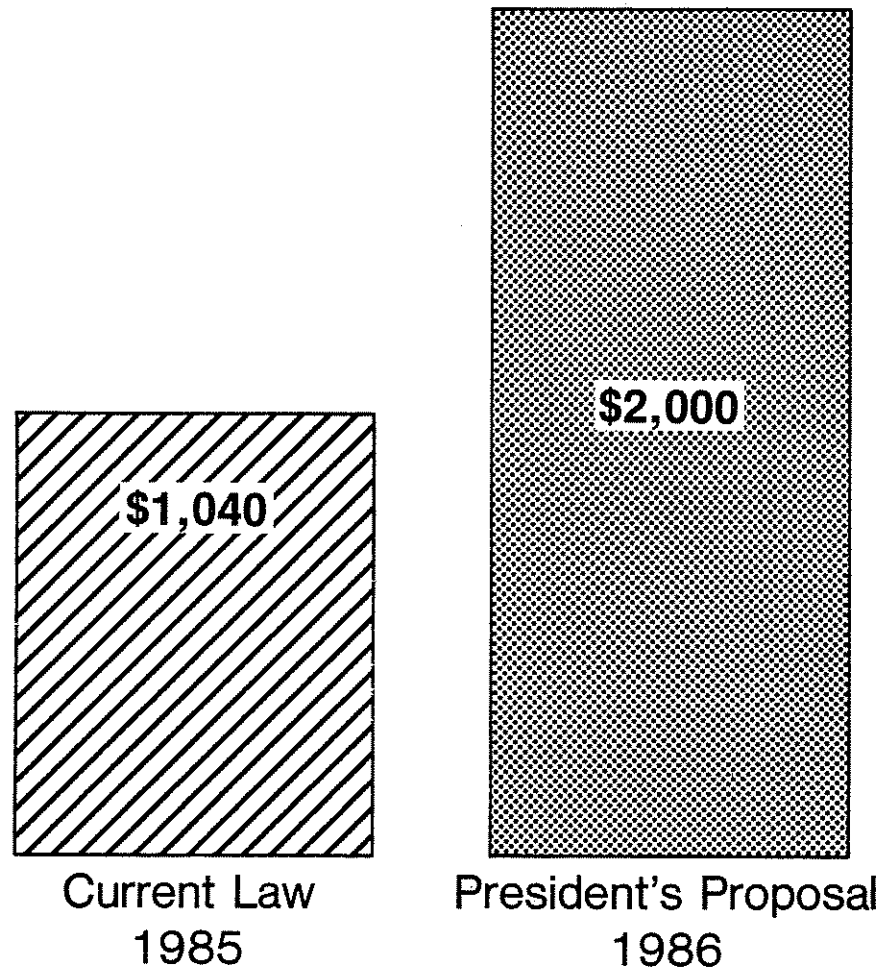


Chart 10

TAX-FREE INCOME LEVELS
Current Law and President's Proposal
(For Taxpayers under Age 65)

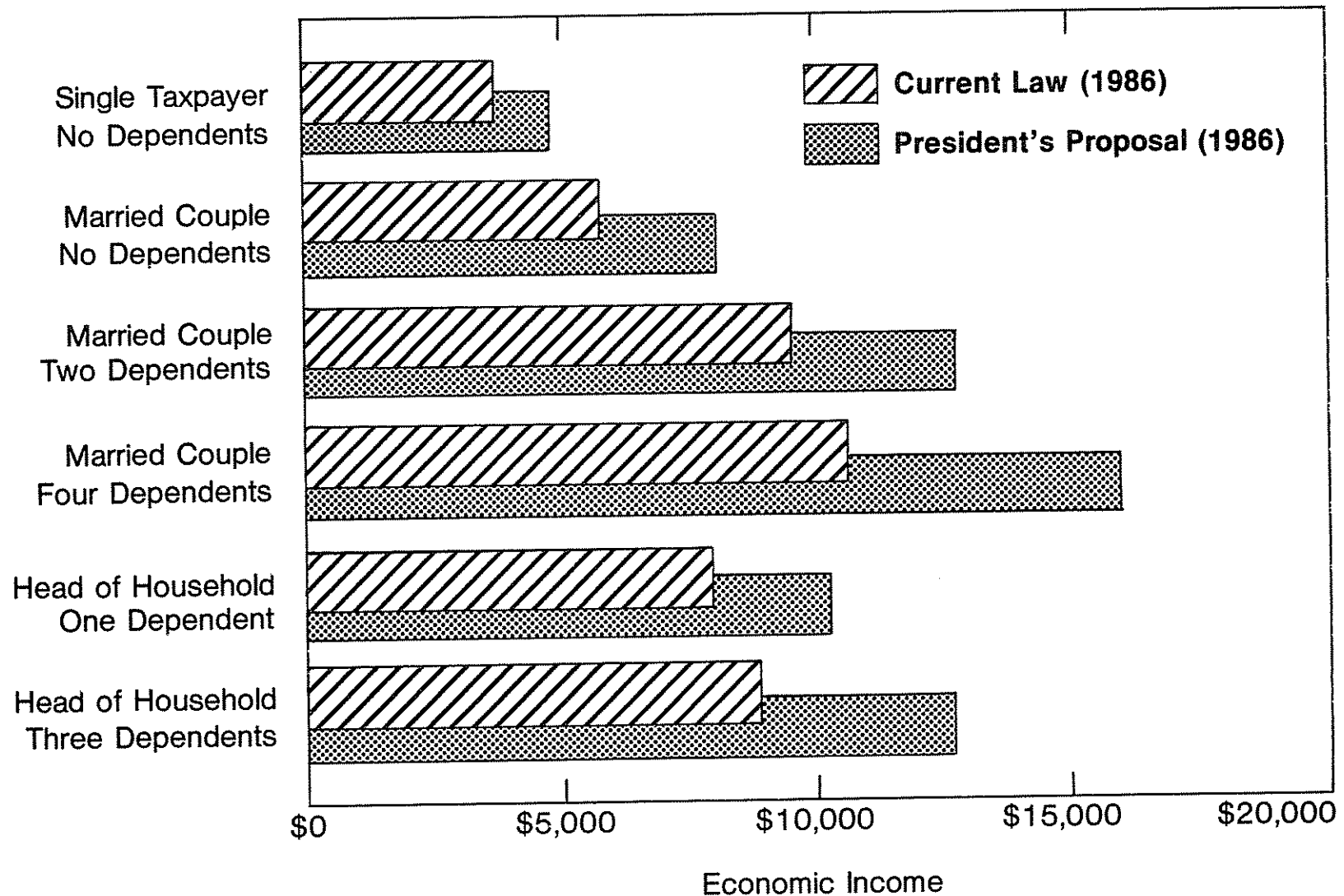


Chart 11

TAX-FREE INCOME LEVELS **Current Law and President's Proposal**

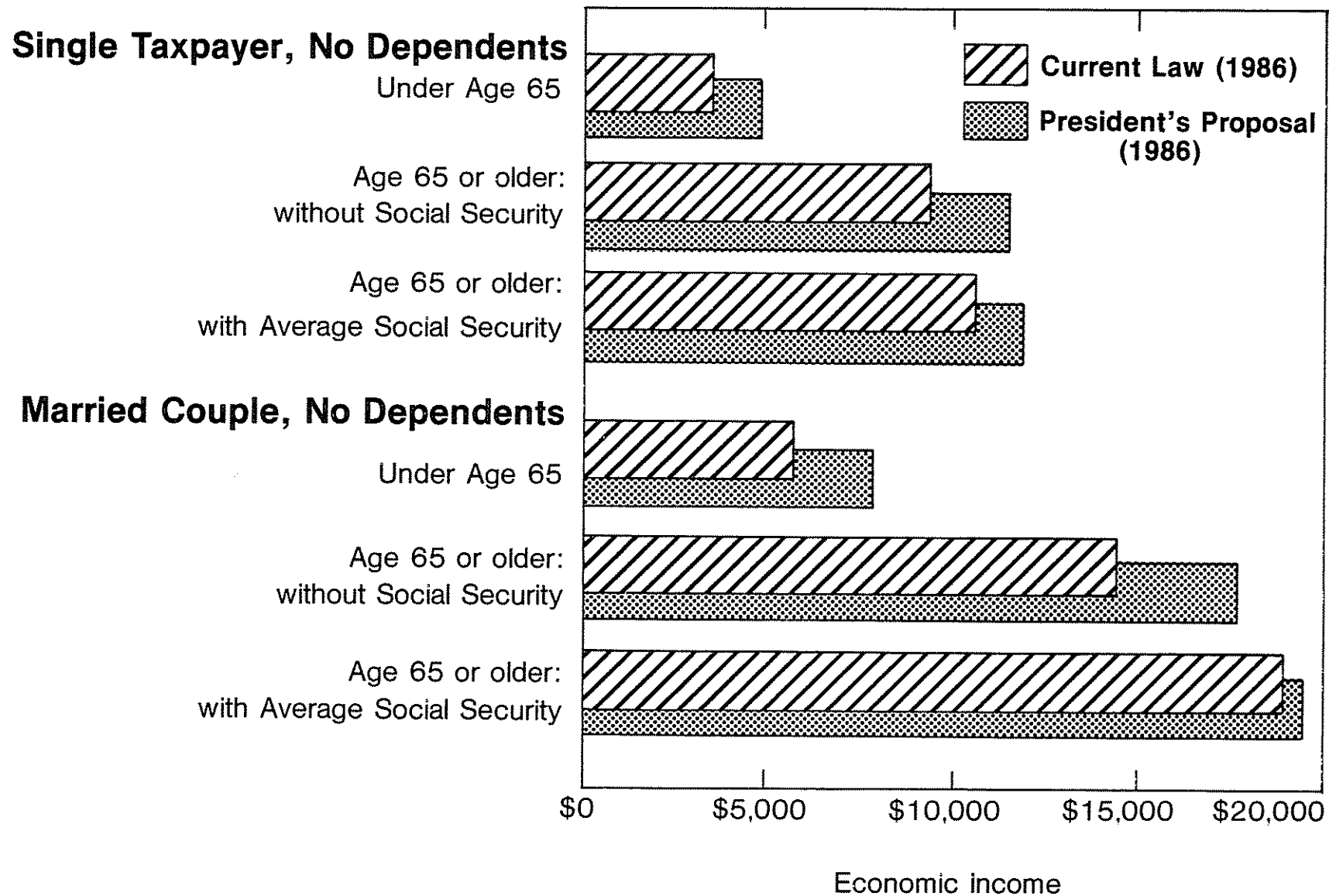


Chart 12

Comparison of the Poverty Threshold and the Tax-Free Income Level Under Current Law and the President's Proposal (1986 Levels)

Status	Poverty Threshold	Tax-Free Income Levels	
		Current Law 1/	Treasury Proposal
Single taxpayer, no dependents			
Under age 65	\$ 5,800	\$ 3,560	\$ 4,900
Age 65 or older:			
No Social Security	5,400	9,383	11,600
Average Social Security	5,400	10,640	11,900
Married couples, no dependents			
Under age 65 <u>3/</u>	7,500	5,830	8,000
Age 65 or older:			
No Social Security	6,800	14,450	17,667
Average Social Security	6,800	18,990	19,500
Married Couples:			
Two dependents <u>2/</u> <u>3/</u>	11,400	9,575	12,798
Four dependents <u>2/</u> <u>3/</u>	15,000	10,598	16,000
Heads of households:			
One dependent <u>2/</u>	7,700	7,945	10,158
Three dependents <u>2/</u>	11,400	9,010	12,558

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1/ Includes expected indexation for inflation in 1985.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

Chart 13

FAMILIES WITH TAX CHANGE Under the President's Proposal

(As a Percent of All Families)

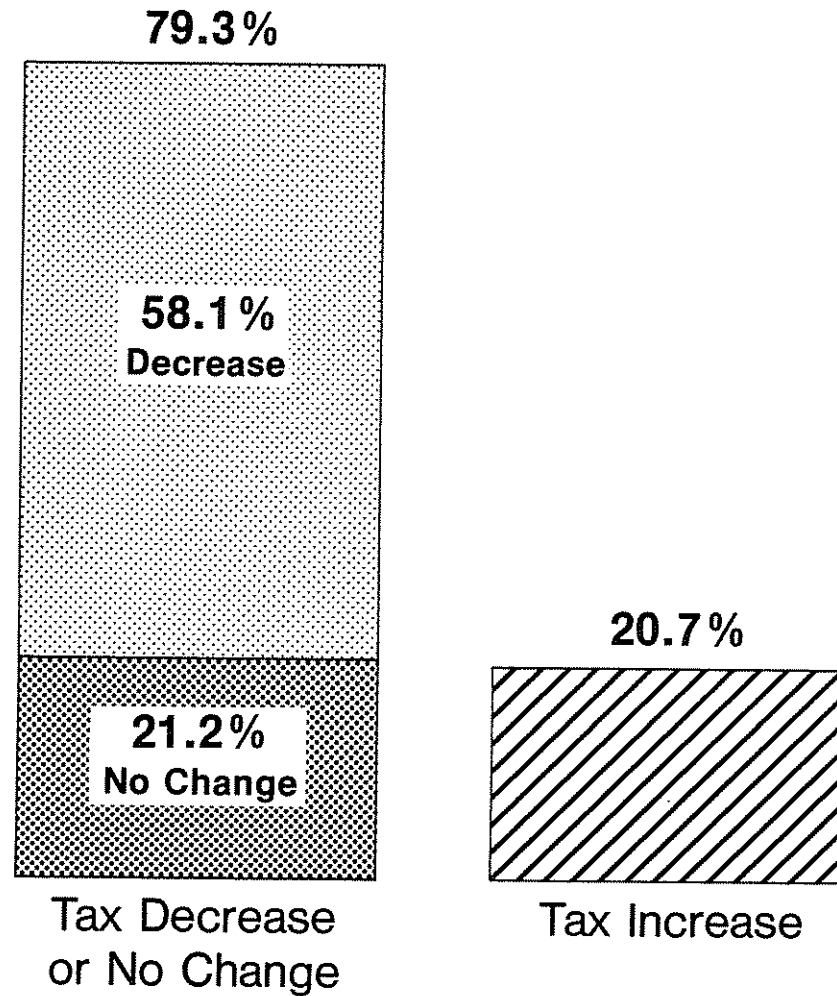


Chart 14
FAMILIES WITH TAX CHANGE BY FAMILY ECONOMIC INCOME
Under the President's Proposal
 (As a Percent of All Families)

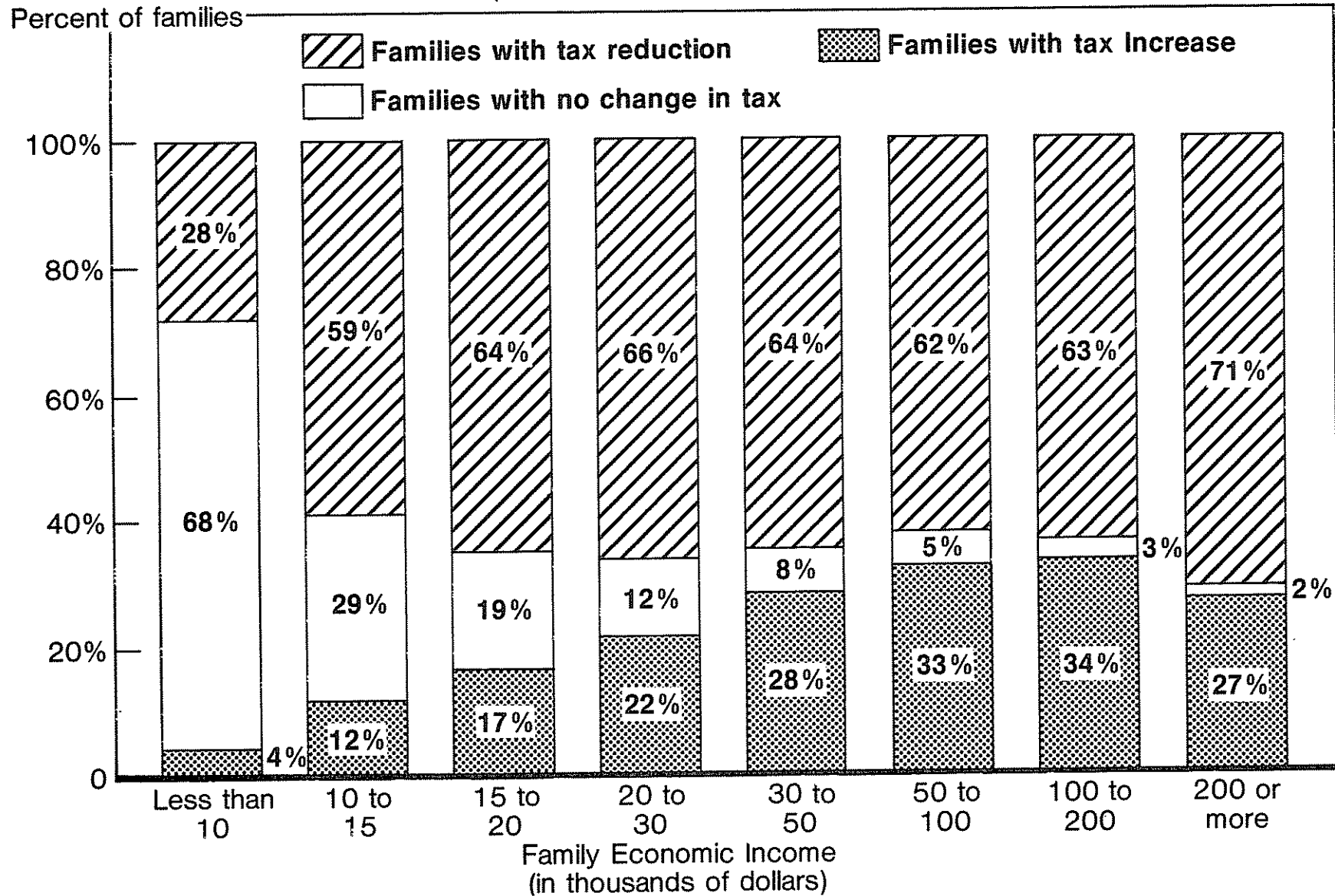


Chart 15

PERCENTAGE CHANGE IN TAXABLE INCOME Under the President's Proposal

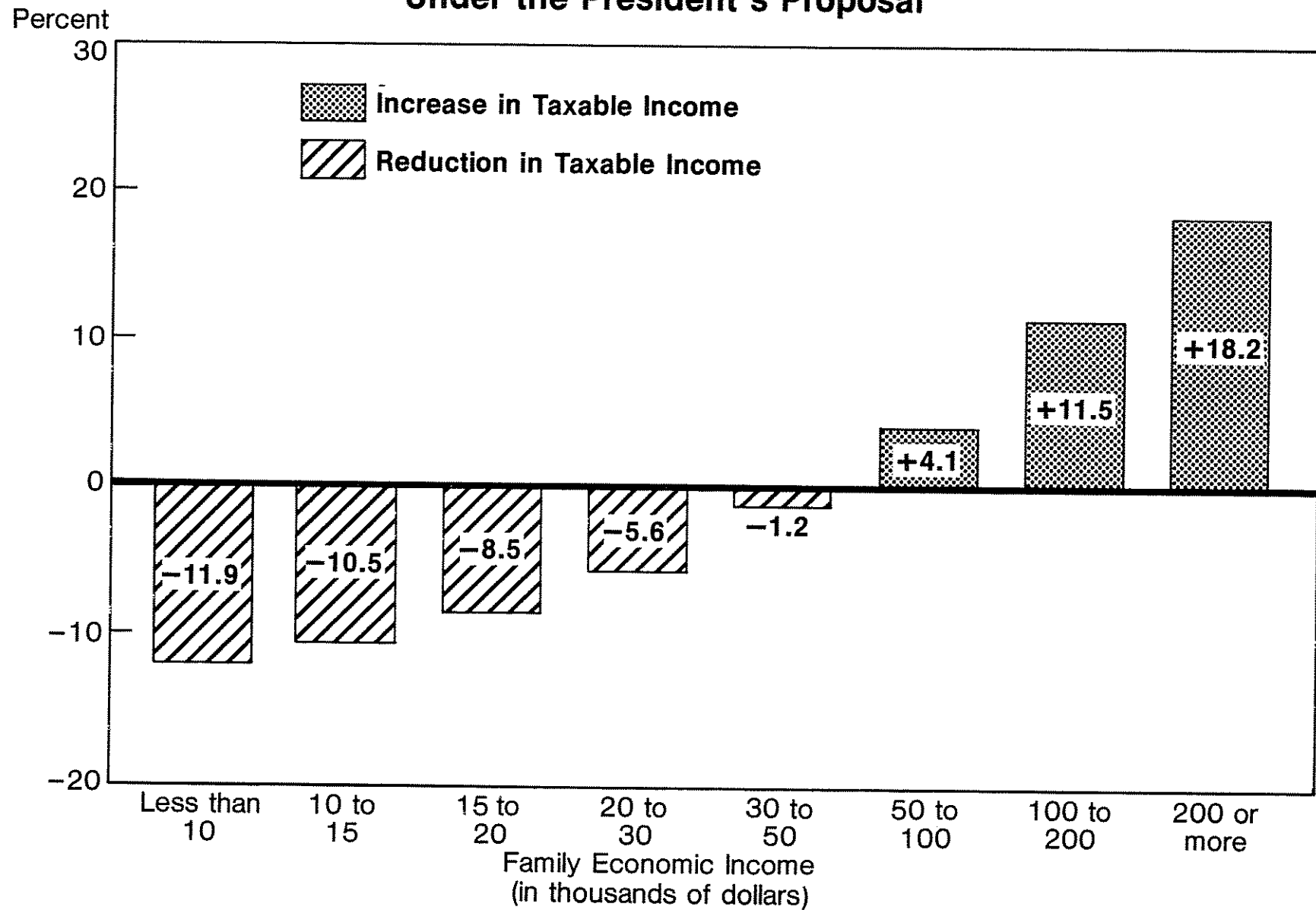


Chart 16

**DISTRIBUTION OF TAXES PAID
BY FAMILY ECONOMIC INCOME
Current Law and President's Proposal**

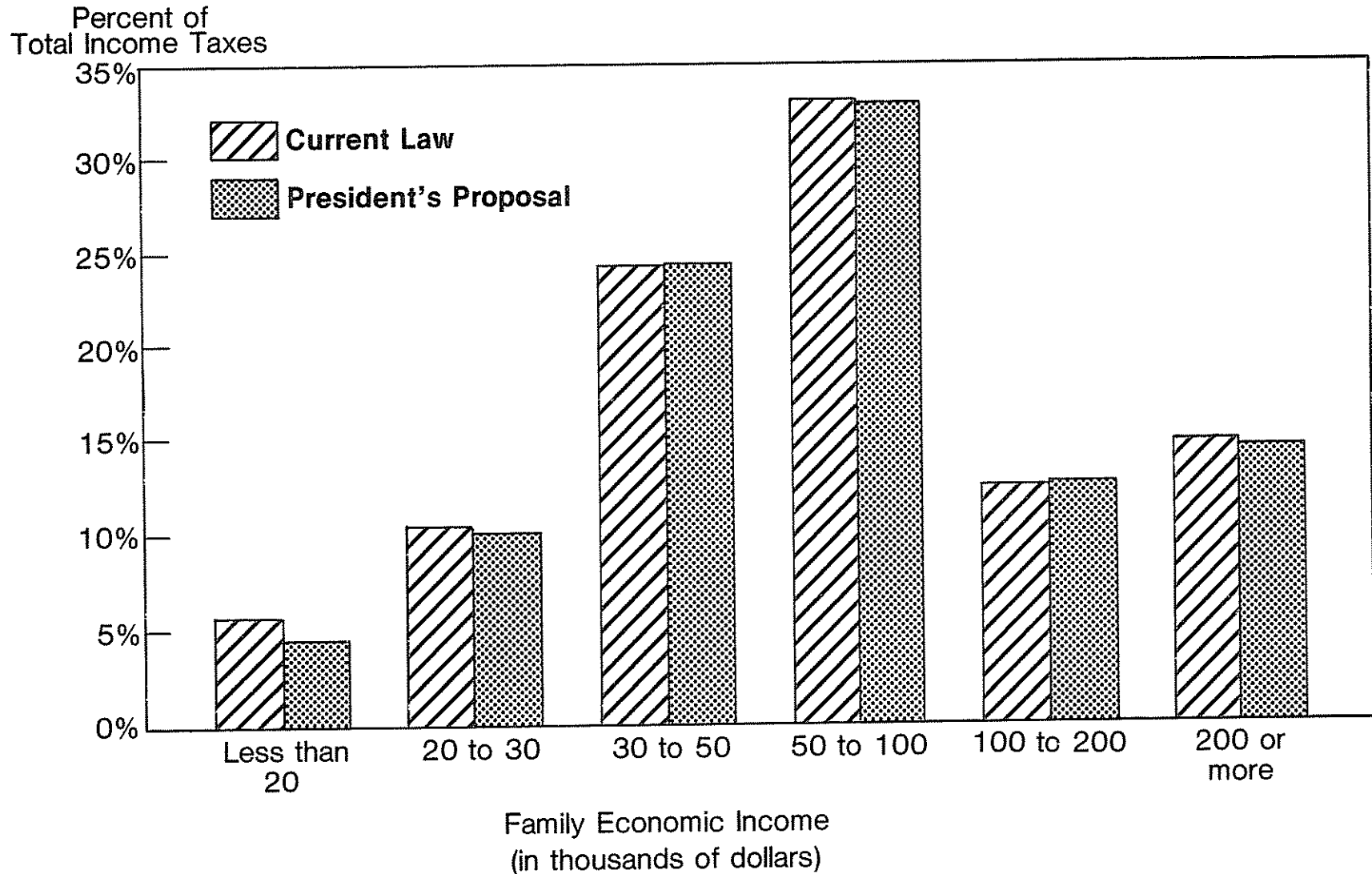


Chart 17

Distribution of Taxes Paid by Income Class

Income Class	Percent of Total Income Taxes Paid	
	Current Law	President's Proposal
Less than \$10,000	0.5 %	0.3 %
\$10,000 - \$15,000	1.8	1.5
\$15,000 - \$20,000	3.3	3.0
\$20,000 - \$30,000	10.3	10.1
\$30,000 - \$50,000	24.3	24.4
\$50,000 - \$100,000	32.7	33.7
\$100,000 - \$200,000	12.3	12.7
\$200,000 and Over	14.8	14.3
Total	100.0 %	100.0 %

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Chart 18

Comparison of Highlights of Current Law, November 1984 Treasury Proposal, and President's Proposal

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Individual tax rates	14 rate brackets from 11 to 50%, indexed	3 rate brackets 15, 25 & 35%, indexed	3 rate brackets 15, 25 & 35%, indexed
Exemptions			
Self, spouse	\$1,080, indexed	\$2,000, indexed	\$2,000, indexed
Dependents	\$1,080, indexed	\$2,000, indexed	\$2,000, indexed
Zero bracket amount			
Single	\$2,480, indexed	\$2,800, indexed	\$2,900, indexed
Joint	\$3,670, indexed	\$3,800, indexed	\$4,000, indexed
Heads of household	\$2,480, indexed	\$3,500, indexed	\$3,600, indexed
Two-earner deduction	Yes	No	No
Earned income credit	Yes (\$550 maximum)	Yes, indexed	Increased and indexed (\$726 maximum)
Child care expenses	Tax credit	Deduction	Deduction
Fringe benefits			
Health insurance	Not taxed	Taxed above a cap	Limited amount taxed
Group-term life insurance, legal services, dependent care, education assistance	Not taxed	Taxed	Not taxed

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Parsonage allowance	Not taxed	Taxed	Not taxed
Wage Replacement			
Unemployment compensation	Taxed if AGI over \$12,000 (\$18,000 if married)	Taxed	Taxed
Workers' compensation	Not taxed	Taxed, but eligible for special credit for elderly and disabled	Taxed, but eligible for expanded and indexed credit for elderly and disabled
Veterans' disability benefits	Not taxed	Taxed	Not taxed
Itemized Deductions			
State and local income tax	Deductible	Not deductible	Not deductible
Other state and local taxes	Deductible	Not deductible, unless incurred in income-producing activity	Not deductible, unless incurred in income-producing activity
Charitable contributions	Deductible by itemizers and nonitemizers	Deductible (above 2% of AGI) for itemizers, but no deduction for non-itemizers or for unrealized gains on contributed property	Deductible for itemizers, but no deduction for non-itemizers
Mortgage interest	Deductible	Deductible, for principal residences	Deductible, for principal residences

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Other personal interest	Personal interest deductible; investment interest limited to \$10,000 over investment income	Limited to \$5,000 over investment income for expanded definition of interest subject to limit	Limited to \$5,000 over investment income for expanded definition of interest subject to limit (with phase-in)
Medical expenses	Deductible (above 5% of AGI)	Deductible (above 5% of AGI)	Deductible (above 5% of AGI)
Tax Abuses			
Entertainment expenses	Deductible	Not deductible	Not deductible
Business meals and travel expenses	Deductible	Deduction denied for meal costs above cap	Deduction denied for 50% of meal costs above cap
Income shifting to children and via trusts	Permissible	Curtailed	Curtailed, except for post-death trusts
Retirement savings			
IRA	\$2,000	\$2,500	\$2,000
Spousal IRA	\$ 250	\$2,500	\$2,000
Corporate pensions	Tax deferred	Tax deferred	Tax deferred
Social security	Generally not taxed	Generally not taxed	Generally not taxed
Capital and business income			
Corporate tax rates	Graduated, up to 46%	33% flat rate	Graduated, up to 33%
Limited partnerships	Losses flow through to partners	No loss flow through	Current law

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Dividend relief	\$100/200 exclusion	Exclusion repealed; 50% dividend-paid deduction	Exclusion repealed; 10% dividend-paid deduction
Depreciation	ACRS	Economic depreciation, indexed	Indexed, with investment incentive
Investment tax credit	6% - 10%	No	No
Capital gains	60% excluded	Indexed, taxed as ordinary income	50% excluded (optional indexing in 1991)
Interest income/expense	Fully taxed/deductible	Indexed, partially excludable/nondeductible	Fully taxed/deductible
Inventory accounting LIFO conformity required	Yes	No	No
FIFO	Not Indexed	Indexed	Indexed
Uniform production cost rules	No uniform rules	Uniform rules	Uniform rules
Installment sales	Deferral	No deferral if receivables pledged	Generally no deferral if receivables pledged
Bad debt reserve deduction	Yes	No	No
Oil industry Percentage depletion	Yes	No; Indexed cost depletion	Phased out with stripper exception
Expensing of intangible drilling costs	Yes	No	Yes

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Windfall profits tax	Will phase out in 1991	Phase-out accelerated	Will phase out in 1991
Financial institutions			
Special bad debt deduction	Yes	No	No
Deduction for interest to carry tax-exempts	Yes	No	No
Exemption of credit unions	Yes	No	No, except for small credit unions
Deferral for life insurance income and annuity income	Yes	No	No, except for existing policies
Exemption of certain insurance companies including fraternal organizations	Yes	No	Yes
Municipal bonds			
Public purpose	Tax-exempt	Tax-exempt	Tax-exempt
Private purpose	Tax-exempt	Taxable	Taxable
Rehabilitation and energy credits	Yes	No	No
Minimum tax on individuals and corporations	Yes	Not necessary	Retain and tighten